DOW THEORY LETTERS INC.

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THE MARKET: Times have changed. Back in the late 1950's I used to spend most of my spare time replying to irrate subscribers who insisted that Dow's Theory was invalid because it took into consideration the Rail Average, an Average (I was informed) which was meaningless since it merely chartered the course of a dieing industry. I have received no such letters for over a year. The fact is that Rails have outperformed Industrials in percentage of advance ever since 1957, and they have most definitely done so during 1965.

The action of the Averages from a Dow Theory standpoint is most interesting at this time. On November 4 the two Averages recorded all-time highs of 961.85 (Industrials) and 237.95 (Rails). A decline occurred, followed by a new rally which saw Rails advance to a second record high of 238.77 on November 15 (see Chart 1). The new Rail high was not confirmed by Industrials. The non-confirmation was accompanied by a second slide, and this time Industrials broke below their November 10 low, thus tracing the first significant downward zig-zag since the June, 1965 low. Another rally got underway, and on November 24 Rails surged to a third record high above 242, but again Industrials failed to confirm.

Thus a series of non-confirmations has been building with Rails pushing to successive all-time highs while Industrials back away from their record high established a month ago on November 4. Any number of theories have been offered to explain the divergent action, the most popular being that Rails are anticipating excellent traffic through next year while Industrials are still reflecting investors' worries about the Administration clamp-down on prices. This may or may not be the correct interpretation, but one thing we do know: the two Averages have never in all market history parted ways for long.

Conclusion: The primary and secondary trends are bullish. The divergent action of the Averages will be resolved by an Industrial rise above the high of 961.85 or a Rail decline into the 235 area.

A few sundry but significant observations might be made at this time. The action of the Industrial Average since the May peak of 939.62 provides evidence of the old truism that primary movements tend to be long and extended while the secondary movements (against the primary trend) tend to be short and violent. Thus the 99 point Industrial drop from the May high to the June low consumed a little over a month's time. But the steady advance back to and above the May high took almost four months or almost four times as long. The time element was bullish in implication. By the same token, when a true bear market starts it will not be surprising to witness a tedious and extended downward trend rather than an immediate collapse accompanied by heavy and obvious selling pressure. Subscribers should remember that the long market movements are in the direction of the prevailing primary trend.

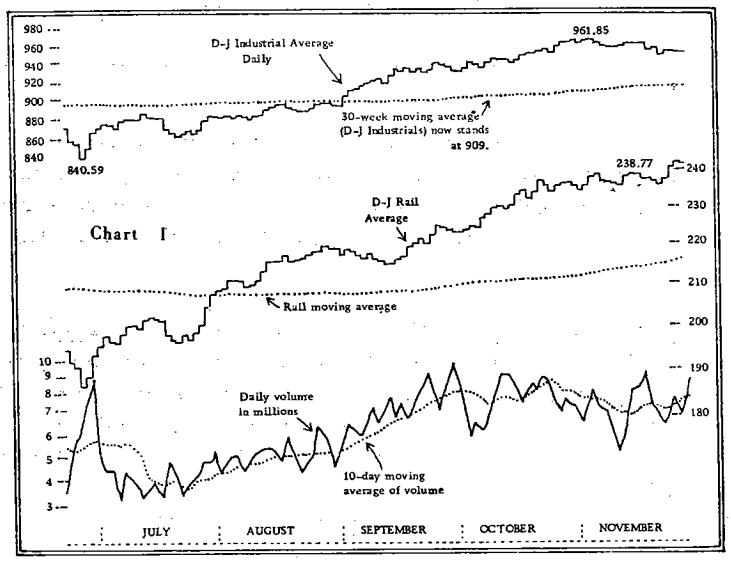
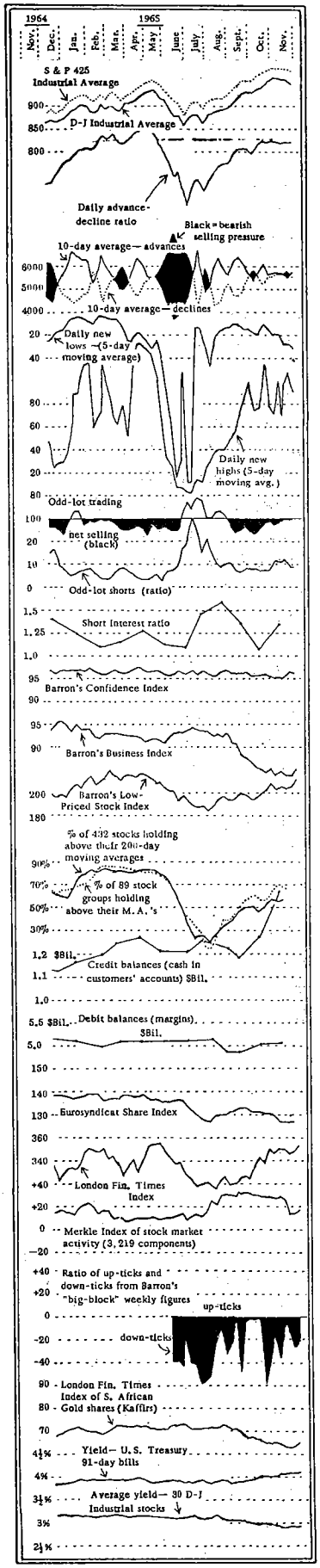


Chart I


1964
1965
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average— advances
10-day average— declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short Interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield— U.S. Treasury 91-day bills
Average yield— 30 D-J Industrial stocks

The Utilities play no part in Dow Theory, but in the past this group has been a fairly accurate indicator of investment sentiment. For instance, as noted in Letter 297, this is the first time since 1949 that the Utility Average (following a reaction) has failed to lead the other two Averages to new bull market highs. Not only have Utilities refused to better their early 1965 high, but last week they broke to their lowest level since September. I would place the Utility action in the same catagory as the desultory action of the D-J 40 Bonds which is discussed in a later section of this Letter.

It is also interesting to observe that following the weakness of the past few weeks the Industrial Average has retreated to within 1% of its May (939.62) high of six months ago. At the same time, Rails have outperformed Industrials and now stand 16 points above their previous 1965 high. Utilities never went to a new high, and the advance-decline ratio also failed to better its May, 1965 peak. On balance, the whole market performance can be labeled bullish (since Industrials and Rails did advance to new bull market highs) but not particularly impressive since only one indicator (the Rail Average) has been able to extend its gains appreciably beyond its May, 1965 high.

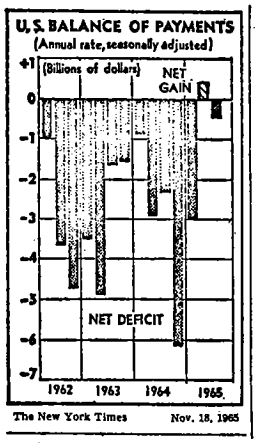
The announcement of a rise in the total short interest on the N.Y.S.E. for the fifth month in a row to a total of 9.8 million must be taken as highly bullish as long as we hold to the premise that the primary trend of the market is bullish. There is a good deal of confusion about the meaning of the short interest. Many believe that a high short interest in itself indicates that the primary trend is bullish. This is not so. But — when a large short interest builds up within a continuing bull market, the implication is that there is too large a bearish element "playing against" the established trend of the market. Past history suggests that bull markets end when "too many" people are bullish, not when there is a large bear element arguing with the primary trend.

SUNDRY COMMENTS: Back in Letter 296 I wrote: "My own opinion — get ready for some surprises regarding Vietnam. McNamara and the Administration have been wrong about the war, Johnson has been wrong in letting McNamara handle the war, Congress recognizes that the war is now a brewing mess...." But from almost all sources we hear about the indispensible Mr. McNamara. For instance, from the Nov. 20 Business Week we read: "The almost incredible variety of Defense Secretary Robert McNamara's roles in sensitive policy areas goes on balooning. The more controversy he attracts, the more President Johnson turns to him." In view of this, the writer was fascinated by this little paragraph which appeared almost unnoticed in the "Washington Whispers." page of U. S. News & World Report (Nov. 29). The implications are little short of sensational.

Secretary McNamara is mentioned increasingly as a likely choice as head of the new Department of Housing and Urban Development. This is the Department that will direct President Johnson's "Great Society" plans for the nation's cities. It admittedly will have a difficult task.

* * * *

Following a lone surplus in the second quarter of 1965, the third quarter results produced another deficit in the U. S. balance-of-payments (see chart). On the old method of figuring, this was a $615 million dollar third quarter deficit, and the deficit is thus running at a $2.5 billions rate per year. With the British pound having recovered, the U. S. now has to face the probability of a return of anywhere from 2 to 3 $billions to Britain (money that was loaned to support the pound). So far this year, U. S. imports are up 12%, exports only 1%, and this plus a huge outflow of dollars via the tourist trade plus the rising expense of the Vietnam war are calculated to produce somewhopping deficits in the period ahead. Conclusion: look for a series of new controls (voluntary or otherwise) to affect many sectors of individual and business life. (Item: Secretary Conner announced that shortly each corporation will be given a formula to calculate a "target" improvement in its overseas investment investment account).



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In a new book, "Stock Market Timing, A New Approach" by Dr. C. Gillett, the standard New Era attitude toward gold is advanced. States Dr. Gillett: "Gold does have utility commercially as in dental use, but the large part of the gold output has been used to augment monetary stocks. However, if gold were treated as any other commodity and could be bought and sold the price would drop so drastically that people would refrain from using it for jewelry."

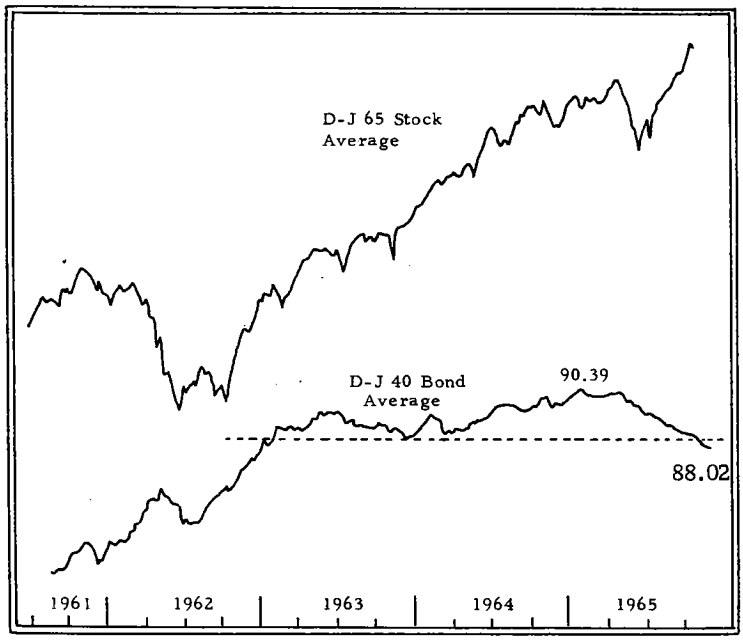
This statement is typical of the part-wishful thinking and part-ignorance which has gripped so many writers and economists over recent years. The fact is that the U. S. has not been a net buyer (actually it has been a net seller) of gold for the past eight years. Thus it can hardly be claimed that the U. S. guarantee to purchase gold at $35 per ounce is the mechanism which has supported the gold price. Furthermore, Dr. Gillett's statement is doubly deceptive in that he puts forth a premise (i.e., that gold may conceivably be treated as any other commodity), a premise which runs counter to five thousand years of human history.

The simple fact is that we are not going to see gold "treated like any other commodity." All history demonstrates that men trust gold, but that they do not (when the monetary chips are down) trust politicians. The current trend in almost all the major central banks of Europe is to reduce dollar holdings and increase gold reserves (at the expense of loss of interest on dollar holdings). That President Johnson fears this trend is seen in his efforts to halt inflation, inflation which would push up U. S. prices, further hurt our balance-of-payments and cause increased losses of gold.

Could 9.8 million shorts be correct, and could the primary trend be turning bearish? They could be correct, but historically it has not usually worked that way. Nevertheless, the story of whether the shorts are right, or whether they are going to be run out in a continuing bull market, will be told by the Averages. A refusal of the Averages to chart a bearish path over the period ahead will put pressure on the shorts, and if this pressure is to exert itself we should see it within the next few months (in the form of a holding or rising pattern in the Averages).

The Composite Chart (Page 1) shows the two leading industrial averages near their record highs with the A-D ratio continuing to form a sideways pattern. While daily new highs have not broken above their 100-120 range, new lows are slowly but definitely expanding. This suggests a slow rise in selling pressure. Odd-lots remain neutral with buying and selling about in balance. The November jump in the short interest to a total of 9.8 million shares moves the S.I. ratio up to 1.34, and this must be taken as constructive for the market. At the same time debit balances rose $80 million, but this still leaves debits well under their late-1963 peak. The credit balances, however, rose $106 million in November to $1.475 billion, and this indicator is approaching its all-time high of $1.508 billion of April, 1961. Obviously, the public is building up a good deal of cash in its accounts, and this is indicative of cautiousness on the part of the public, a constructive sign for the market. The percentage of stocks holding above

their moving averages rose to 60% last week, highest level since May. Barron's big block transactions showed a ratio of minus 22 last week, which is more of the same kind of distributive action which has characterized these indices since June. The Kaffirs (S. African gold) index climbed 1.4 points last week, which could represent the beginning of a reversal in trend. (I recommend purchase of a comparatively new growth mine at this time, Western Areas at a price of 3½). The spread between the average Dow yield and the yield on U. S. Treasury bills continues at the widest level in history.



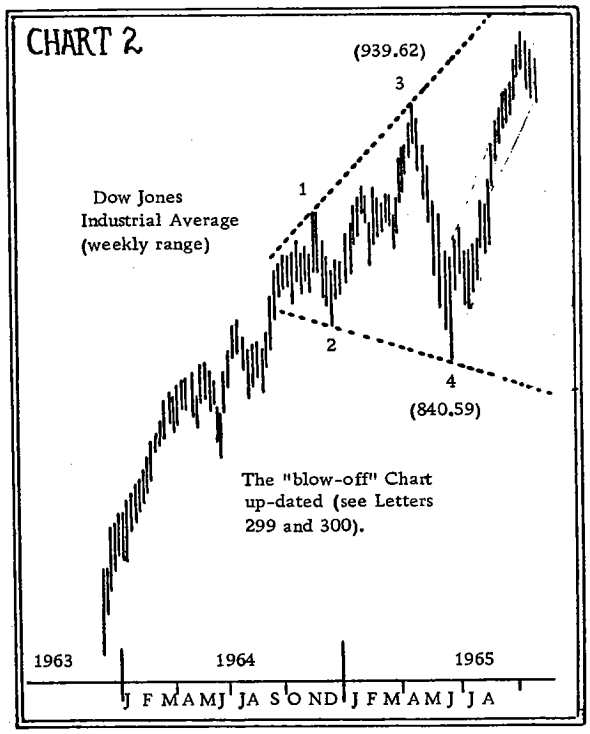
Conclusion: The technical underpinnings of the market appear reasonably strong. Nevertheless, since early November progress has been slight, and the market could be putting itself in position to reflect trouble in December or the first quarter of 1966. So far, the only hints of danger are being given by the divergent action of the Industrial and Rail Averages.

THE D-J 40 BONDS (see chart) have now broken below their 1963 and 1964 lows, and this Index is currently at its lowest level since 1962. This is a significant breakdown, and it is worth further analysis. In the Traders Research Breakout Service (1431 Pearl St., Alton, Ill., 62003), my friend Dan Merkle offers an expert discussion of the importance of the 40 bonds and the meaning of this latest action:

"Monday's decline pushed the D-J 40 Bond Average under its critical reversal point. The interpretation of the '40-Bonds' is now bearish. This money flow indicator is a gauge of market climate rather than a timing index. When these lower grade bonds are trending down it is probable that the money resulting from their sale is being placed in higher grade liens; thus, because of this waning confidence of professional money men, the atmosphere of the stock market is one of doubt.

"When the '40-Bonds' are rising, inflationary forces are at work, and very little can go wrong with the securities markets. It is a safe bet to make purchases when a '40-Bond' uptrend is in progress. On the other hand, when an intermediate downtrend for the '40-Bonds' is evident, it is highly dangerous to take long term positions, even though the popular stock averages may temporarily continue higher. The '40-Bonds' topped out nine months ago in February, 1965. Historically, the '40' have led stock prices from six months to slightly more than a year and one-half; so now it appears we are nearing the end of this great intermediate-term bull market which began more than three years ago in 1962."

INDUSTRIALS: In Letter 292, 293 and again in Letter 299 I discussed the peculiar pattern which had been forming in the D-J Industrial Average. In Letter 299 I wrote: "...it is well to note the formation of the four reversal points on the Industrial Average with the fifth reversal point somewhere ahead (see accompanying chart). The dangerous looking (highly erratic) structure which has been in the process of forming since late 1964 will immediately bring to the minds of older subscribers the possibility of a broadening top. The broadening top is a five-point reversal pattern with each low below the preceding low and each high above the preceding high. Such patterns are extremely rare, and the only completed broadening top ever to appear in the Averages occurred in mid-1957 prior to the 100 point drop."



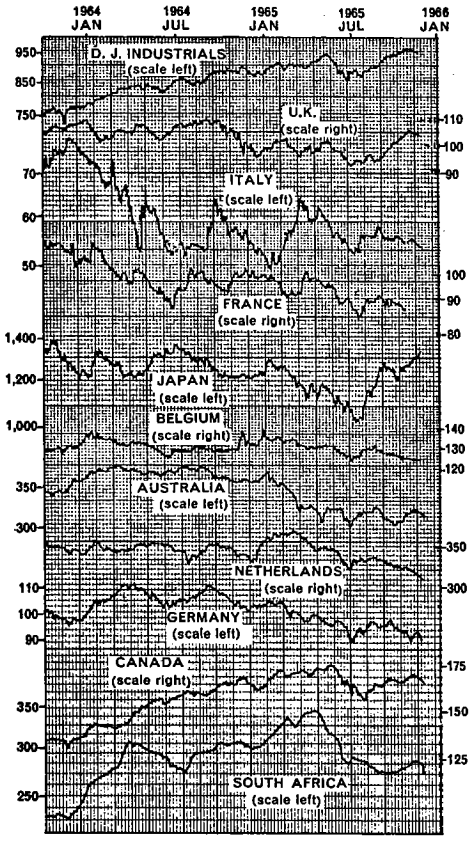
In order for the broadening structure to be complete, I wrote, Industrials would have to push above point 3 (above the old high of 939.62, then turn down and smash through the lower trendline (or below point 4). On November 4 the Industrials recorded an all-time high of 961.85, a figure which took them within "shooting distance" of the upper trendline on the chart. Over the past few weeks Industrials have faltered. It remains to be seen whether the broadening concept is valid. If it is, the action ahead should be marked by violent movements and a broad declining trend in the Industrial Average.

WHAT THEY'RE SAYING: (From Alden R. Well's Monetary Report, Nov.) "Of these fifteen (foreign) currencies, the dollar is at a discount with twelve and at par with three. Two currencies, the French and Swiss francs are at their ceiling....Our State Department learns very slowly that relations between governments do not rest on sentiment. The British this past year have cooperated with our foreign policies because they have been dependent on us. Should our dollar become so weak that all other major nations are masters of their own houses, but we are dependent, then they will make the decisions. Conversions of dollars into gold would accelerate."

(From E. Geo. Schaefer, Nov. 27) "As we move along into 1966 my belief is that we will see many more governmental influences, restrictions and controls...As I see it we will have enormous production of just about everything, but the war controls now in force, and those to come later will finally put a major profit squeeze on our corporations...In time I feel that the entire bull market will become worn out with the struggle of moving any higher, and then – probably at some point in 1966, buyers will refuse to bid up prices as sellers begin to dominate the market. At that same point it is entirely possible that a new major bear market will have been born, and if so, today's prices will look sky-high to all of us."

(From the Janeway Service, Nov. 23) "Mystery explained. Treasury Secretary Fowler has now made it official! In his Chicago speech to the Executive Club last week, he finally spelled out the Administration's tortuous triple-purpose plan intended: (1) to hold down industrial prices, (2) therefore, to hold down interest rates, (3) and, nevertheless, to hold back investment in, and lending to, overseas markets where prices, rates and profit margins are higher...Before Secretary Fowler spelled out the Administrations' three-point program, no one could understand what the Administration was up to; and only a very few well-informed people realized how close it was to a serious breach with Business. Now that the Administration has shown its hand, everyone can see that Johnson has taken on a fight with Business; and the Administration is in worse shape than before."

FOREIGN MARKETS: The accompanying chart shows the U. S. and 10 leading foreign markets. The U.K. is in a secondary uptrend as is Japan's market. Italy has built a series of two ascending bottoms and could be in the process of turning up. All the rest are in established downtrends with the French, Belgian, Dutch, German and So. African (Industrial) averages at or close to lows for the year. The boom in Europe is slowly being squeezed off by high interest rates and massive new productive facilities. This is going to mean a concerted export offensive, and the primary export target is and will be the U. S. This explosion in world production is one of the factors preventing a real rise in the price of goods throughout the world (actually, over the past year or so it is the cost of services, not merchandise, which has risen).



The D-J Industrial Average has been noticeably laggard during the past month. The undisputed "leader of the Dow pack" is General Motors. What GM does over the period ahead could set the tone for the entire market (at one time this same statement could have been made of U. S. Steel). Note on the Traders Research daily chart that GM is now below its May all-time high. More important, GM's relative strength (RS) line has begun to weaken and the daily RS line is now below the 200-day moving average of RS (dotted line on chart). With GM's RS line turning down, my guess is that GM could be a leader on the downside during any forthcoming period of market weakness. I might add that both Chrysler and Ford appear to have discounted the best of the auto news. Ford formed a "triple top" in the 63 area and has turned down. Chrysler hit its peak in 1964, and Chrysler's volume on the 1965 rally has been noticeably under its '64 volume. I believe the auto group has "topped out," and that these shares should be sold.

Dome Mines is the largest gold mining interest in the Americas. The stock may be purchased both as a hedge against devaluation and as a hedge against trouble in Africa. Technically, DM is now quite interesting. Note on the small weekly chart that DM has built a series of four rising bottoms and has now pushed above its 200-day moving average (dotted line) which stands at 37. I will repeat that I do not believe subscribers should "trade" the golds. They should be purchased when attractively priced and held as a hedge against monetary upheavals which could be a fact of life in the period ahead. (Charts below from Quote Digest, 110 N. Lorraine, Wichita, Kan.)